

COMMENTS ON ESMA DISCUSSION PAPER: “UCITS SHARE CLASSES”

INVERCO recognizes the value of building a common framework for share classes at EU level as well as ESMA’s revised approach following the first discussion paper published on 23th December of 2014, given that, in this second discussion paper, ESMA suggests the establishment of common principles that all share classes ~~should~~ must comply with, instead of establishing specific scenarios.

Notwithstanding, INVERCO would like to draw attention to the following general comments:

1. Definition of compartment and classes. The discussion paper departs from the existence of **compartments (or “sub-funds”)**, as separate parts of a common fund vehicle, and **shares**, as different types of units or shares belonging to the same UCITS or compartment, which differ from each other by different characteristics, however, all of them share a common investment objective and common pool of assets.

The paper seeks to define, only, the concept of share classes, even though ESMA implicitly recognizes the nonexistence of a common regulatory framework at EU level for a concept of compartment.

The Directive, same as it happens with shares, stays silent on the definition of compartment, besides, it does not require the segregation of assets between different compartments of a common fund. In fact, ESMA considers that the segregation requirement comes from the interpretation of the Directive, and not from its literalness, which is the reason why in some jurisdictions there is no segregation (*“While asset segregation between sub-funds is not mandatory in some jurisdictions, ESMA is of the view that the UCITS Directive should be interpreted in such a way that it requires the segregation of assets between compartments”*).

Moreover, in the configuration of compartments exists important differences across countries, for instance the joint tax liability between compartments under Spanish law has hampered the development of this figure, while in other countries as Luxemburg, the CIS by compartments represent more than 90% of the overall.

In addition to the above, and the fact that, according to ESMA, the differences which justify the existence of shares are found in the execution of certain kinds of derivatives-hedge arrangements whose evolution would affect only the overlay classes, it rises doubts about the differences that, in the view of ESMA, really exist between compartments and classes and, whether it is possible to consider the existence of a common pool of assets in all classes, while some of these assets, would only affect some of those share classes.

Therefore, **INVERCO considers that the discussion paper should not only set up the definition of classes but also the definition for compartments, otherwise it makes confusion between both definitions, which, by all means, should be avoided.**

2. Level playing field and lack of matching definitions between ESMA’s share classes and Spanish regulation. The definition for share classes introduced by ESMA, regarding share classes with risk-hedged through derivatives, does not match with the definition of share classes already regulated in the Spanish law.

According to the article 7 of law 35/2003 of Collective Investment Schemes, share class means a common pool of assets for all classes, while they could differentiate from each other by the following elements: currency denomination, the policy in order to distribute returns or how commissions must be applied. However, the Spanish law does not take into account the possibility of assigning, in terms of accounting, particular assets and their returns to specific share classes (as it would be the case for derivatives involved in currency-risk hedging for specific share classes). Therefore, since accounts should reflect a true image of the net worth, if, the currency-risk hedging derivative set for a given share class becomes part of the common pool of assets¹, in accounting, active assets and its performance should be applied to all classes and not just some of them.

That being said from a conceptual perspective, it is true that in the practice;

- a) The creation of share classes implies advantages that have been exposed by ESMA² which, in the case of being admitted, they would benefit the Spanish mutual fund managers as well, who currently cannot manage share of classes with any purposes set out by ESMA (particularly, currency- risk-hedged, duration-risk-hedged or volatility-risk-hedged).
- b) With an appropriate risk managing, the probability of negative effects on unit-holders of other share classes, resulting from the use of risk-hedging derivatives in specific share classes is very limited, as ESMA has stated³.
- c) In spite of accounting considerations made previously, it must be understood that international accounting regulation establishes these kind of accounting assignments just for particular share classes, since it is the only way to justify the existence in some jurisdictions where the use of share classes with derivative overlays are able to be accounting just the share classes which are overlaid.

As a consequence, **it should be considered that in order to set up the most appropriate common regulatory framework at EU level, ESMA should define the concepts of compartments and share class (and not only share class). Moreover, in case that under this common regulatory framework, the creation of share classes that can be differentiated by types of risk-hedge are admitted, then, domestic jurisdictions, that do not contemplate this possibility, must modify their regulation in this sense, and, therefore, permitting mutual fund managers from different countries compete under equal circumstances.**

On the other hand, the questions suggested on the discussion paper have been replied under the following condition: **if the definition of share class widens at EU level, this definition must be adopted by the Spanish regulation. Otherwise, taking into account cross-border distribution, passport UCITS and Spanish CIS would find an unequal scenario.**

¹ Paragraph 23

² En el párrafo 12 se enumeran la reducción de costes, la adaptación a las necesidades de los clientes, las economías de escalas o la agilidad en su lanzamiento, entre otras.

³ Párrafo 25

1. - Would you agree with the description of share classes?

Yes, we agree with the description of share classes stated by ESMA, according to it, share classes confer different rights/characteristics to certain group of investors, starting as the investment in a common group of assets.

2. - Do you see any other reasons for setting up share classes?

The included reasons in ESMA's discussion paper for developing share classes are sufficiently exhaustive in order to reflect the current practices within the industry.

3. - What is your view on the principle of "common investment objective"?

At the beginning, the "common investment objective" as common denominator of all share classes within the same CIS/compartment and related to the investment in a common group of assets is adequate. As indicated in ESMA's discussion paper, starting from that common objective, share classes would permit the adaptation to the special characteristics of the certain group of investors.

Under this scenario, share classes which bring specific hedging strategies through derivatives would allow to neutralize the specific risks of a particular share class. Thus, for instance, without the appropriate currency-risk-hedge, in a CIS/compartment, those investors established out of the currency area in which the CIS/compartment is based, would be affected by certain risks that do not undertake the rest of the investors.

Including risk-hedge in share classes seems adequate, provided that operatively it would be possible to attribute to that specific share class, not only the transaction costs (leading to least profitability, due to contribution with collaterals and the inherent costs for operating with derivatives) but also the impact of the fluctuations of the derivatives value on the total amount of assets. Nevertheless, it is important to bear in mind that, given the nonexistence of legal segregation of assets; the "contagion-risk" between share classes cannot be completely deleted.

4. - Which kinds of hedging arrangements would you consider to be in line with this principle?

According to the answer given in question number 3, we consider sufficient those hedging arrangements which allow to operatively attribute to the particular share class (which benefits from the hedge), not only the costs related to the operation with derivatives but also the impact of the fluctuations of the derivatives value on the total amount of assets.

5. - What is your view on the principle of "non-contagion"?

Given that there is a common pool of assets for all share classes, it is mandatory that additional risks coming from derivatives for a particular share class should be monitored and mitigated in order to avoid affecting the other classes. However, as it has already been pointed out, as there is no legal segregation of assets, "contagion-risk" between share classes cannot be completely eradicated.

The cost for using derivatives has to be supported only by the share class whose particular risks are being hedged. Therefore, it is necessary to articulate an accounting process that would allow

attributing costs of risk-hedge derivatives to the particular share class, so that this process would permit to reflect the net asset value of the particular share class and do not impact in the net asset value of the rest.

6. - Are you aware of any material evidence of investors in one share class suffering losses as a result of the crystallization of risk in another share class?

The legal configuration of share classes under the Spanish regulation blocks the existence of “contagion-risk”, therefore it does not exist any precedent.

7. - Where do you see a potential for contagion risk arising from the use of derivative hedging arrangements? What are the elements of this contagion risk?

Please refer to our answer to question number 5.

8. - Do you agree with the operational principles set out in paragraphs 28 and 29?

Yes, except for letter D) in paragraph 28 that requires that UCITS have to evidence ex ante that the implementation of risk-hedged derivatives will drive, for a particular class, to a better alignment with its specific investor’s profile.

As a general principle, risks-hedging strategies of certain risks, give, by nature, a better alignment with potential investors who are averse to the risks being hedged, therefore, requiring an accreditation “ex ante” of this general principle, it would become a mere administrative process without added value.

9. Do you consider the exposure limits in paragraphs 29.b and 29.c to be appropriate?

We consider that the limit of paragraph 29.c), related to under-hedged, should not perform as limit but only as a reference.

10- Which stresses should be analyzed as part of the stress tests?

Due to the legal configuration on share classes under the Spanish regulation, there is no practical experience on this question.

11- Which hedging arrangements would you consider as compatible with the operational principles outlined above?

See the answer given for question number 4.

12- Are there additional operational principles that should apply to address the non-contagion principle?

We consider the nonexistence of any additional operational principles.

13. - What effect would these additional measures have on the compatibility of the operational principles with further hedging arrangements?

N/A

14. - What is your view on the principle of “pre-determination”?

In general, INVERCO agrees with the principle of “pre-determination” since risk-hedging derivatives (in case to be introduced by a particular class) for share classes, must be applied in a systematic way, this means, not permitting fund managers to apply the overlay or not.

However, it would be better to leave certain room to the fund managers as for what kind of instruments (forward, swap) they could use for the hedging strategy. It is important to publish the existence of specific risk-hedge classes and its implications to the investors in these UCITS, but it should not be necessary to inform about the concrete terms on how the derivative overlay is articulated.

15. - Are there additional requirements necessary to implement this principle?

No, we think the requirements set out in paragraphs 31 to 34, are enough.

16. - What is your view on the principle of “transparency”?

Transparency is essential to investors, they should be aware of all the relevant information in order to adopt their financial decisions, understand the risks and performance, but without overloading the investor with information with no value.

17. - Do you consider the disclosure requirements to be sufficient?

The current UCITS regulation already has disclosure requirements so that the investors could be informed of the existence of share classes, therefore, transparency requirements as set out in paragraphs 35 and 36, are sufficient.

18. - Notwithstanding the fact that ESMA considers the above operational principles on transparency as minimum requirements, which modifications would you deem necessary?

None.

19. - Do you see merit in further disclosure vis-à-vis the investor?

No, according to answer given for question 16, providing the investors with exhaustive, technical and detailed information on how risk-hedge derivatives operate for a particular share class would not be appropriate, and it exceeds the purpose of the transparency.

20. - If a framework for share classes, based on the principles as outlined in this paper, was introduced at EU level, what impact on the European fund market could this have?

INVERCO fully supports an EU framework for share classes, framework, which should be spread to a compartment definition as well.

For the purpose of harmonization, it should be of good use to include as well, operational principles on how share classes might interact, so that Member States in order to implement share classes have the same operational measures, specially, for those particular classes with derivative-risk-hedge. Otherwise, taking into consideration cross-border distribution, this could lead to unequal situations and disadvantages in competition across the different member states, for instance, those States that establish more flexible operational systems than the others.

21. - Given ESMA's view that certain hedging arrangements currently in place might not be compliant with the common principles of share classes as outlined above, which kinds of transitional provision would you deem necessary?

The definition for share classes given by ESMA in its discussion paper considers a broader definition than the Spanish legislation, therefore its application would not require any transitional provision for the Spanish classes, being necessary the modification of national regulation in order to allow the application of this definition.

Madrid, 24 de mayo de 2016